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No. 91-587

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.; NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS; NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, INC.; NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS; NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS; PROFESSIONAL INSURANCE AGENTS OF PENNSYLVANIA, MARYLAND AND DELAWARE, INC.; INDEPENDENT INSURANCE AGENTS OF DELAWARE; THE DELAWARE ASSOCIATION OF LIFE UNDERWRITERS; and AMERICAN COUNCIL OF LIFE INSURANCE,

Petitioners,

v.

CITICORP,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether Section 4 of the Bank Holding Company Act applies to all nonbanking subsidiaries of a bank holding company, whether directly or indirectly owned, and thus prohibits a bank holding company from acquiring indirect ownership of an insurance company.

2. Whether an order of the Federal Reserve Board, which has exclusive authority to administer the Bank Holding Company Act, deserves less deference merely because other administrative agencies, who have no authority to apply that Act, disagree with its interpretation of the Act.

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No. ———

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Petitioners,

v.

CITICORP,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITION FOR WRIT OF CERTIORARI

Petitioners Independent Insurance Agents of America, et al., respectfully pray that a writ of certiorari is issued to review the judgment of the United States Court of Appeals for the Second Circuit entered on June 10, 1991.[1]

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[1] In addition to the parties listed in the caption to this Petition, the parties below were the Board of Governors of the Federal Reserve System, the State of Delaware, and the Delaware Bankers Association.

OPINIONS BELOW

The June 10, 1991 opinion of the United States Court of Appeals for the Second Circuit is reported at 936 F.2d 66 and is reprinted in the Appendix to this petition at 1a ("Pet. App."). The order of the Board of Governors of the Federal Reserve System is reported at 76 Fed. Res. Bull. 977 (1990) and is reprinted in the Appendix to this petition at 22a.

JURISDICTION

The United States Court of Appeals for the Second Circuit entered its decision on June 10, 1991. By orders of this Court dated August 28 and 29, 1991, the time for filing this petition was extended until and including October 8, 1991. Jurisdiction is conferred on this Court by 28 U.S.C. Sec. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 2(g)(1) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. Sec. 1841(g)(1), provides in relevant part:

> For purposes of this chapter—
>
> (1) shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company.

Section 4(a)(1) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. Sec. 1843(a)(1), provides in relevant part:

> Except as otherwise provided in this chapter, no bank holding company shall—
>
> (1) after May 9, 1956, acquire direct or indirect ownership or control of any voting shares of any company which is not a bank.

Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. Sec. 1843(c)(8), provides in relevant part:

> The prohibitions in this section . . . shall not . . . apply to—
>
> (8) shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, but for purposes of this subsection it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent, or broker. . . .

STATEMENT OF THE CASE

On May 30, 1990, the Delaware Legislature passed a new law conferring broad insurance powers on certain out-of-state bank holding companies that had been permitted, by virtue of an earlier law, to acquire limited-service banks in Delaware. Under that earlier law, these banks were required to have at least 200 employees in Delaware within two years, were permitted to have only one branch available to the public and, in general, were barred from marketing any product or service to the substantial detriment of pre-existing Delaware banks. 5 Del. Code Ann. Secs. 801-07. A number of New York bank holding companies, including Citicorp, had used the earlier law to acquire a limited-service Delaware bank.

The new Delaware legislation gave these limited-service banks the new power to own insurance entities that could establish offices in any state, although their insurance activities in Delaware were strictly limited. Pet. App. 24a. These special banks were authorized to underwrite and sell insurance either through a specially-defined and separate department (or division) of the bank, or through a separate subsidiary wholly-owned by the bank.[2]

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[2] The so-called "department" or "division" could not be termed a part of the bank in the normal sense of the term. Liabilities of the insurance department are deemed not to be liabilities of the bank,

It was the ownership of insurance companies by these limited-service banks that sparked the instant litigation. On the same day that the Delaware law was enacted, the insurance-agent petitioners filed a protest with the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "Board").[3] The protest was grounded in a basic, undisputed rule of law: Bank holding companies are not permitted to acquire insurance companies or agencies. Section 4(a) of the Bank Holding Company Act ("Act") bars the acquisition of any nonbanking company, subject to certain exceptions set forth in Section 4(c) of the Act. Section 4(c)(8) specifically states the general rule that a bank holding company may not own any entity that sells or underwrites insurance.[4]

The protest argued that this rule could not be circumvented merely because ownership of the insurance entity was held in the name of the limited-service bank which, in turn, was owned by the bank holding company. Although the direct activities of a subsidiary *bank* have been held not to be subject to Sections 4(a) and 4(c)(8),[5] the petitioners explained that the general prohibition on ownership of insurance entities applies to all *nonbanking* companies, whether held directly or indirectly by the bank

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and vice versa. Limited liability is, of course, the *sine qua non* of a separate corporate status. Pet. App. 31a. This case does not directly concern the propriety of these insurance divisions.

[3] Petitioners include major trade associations representing insurance agents in Delaware and across the Nation. The petition for enforcement was soon joined by petitioner American Council of Life Insurance, which represents the interests of the Nation's life insurance companies.

[4] The exceptions set forth in Section 4(c) and the specific insurance exceptions of Section 4(c)(8) are irrelevant to this case.

[5] *Independent Ins. Agents v. Board of Governors*, 890 F.2d 1275 (2d Cir. 1989), *cert. denied*, —— U.S. ——, 111 S. Ct. 44 (1990) ("*Merchants II*").

holding company.[6] Thus, the petitioners specifically objected to Citicorp's transfer of ownership of an insurance underwriter, Family Guardian Life Insurance Company, to its limited-service Delaware bank.[7]

On September 5, 1990, the Federal Reserve Board ordered that Family Guardian, by then an indirect nonbank subsidiary of Citicorp, immediately cease all insurance activities, except those limited credit insurance activities permitted by the Act itself. The Board concluded that Citicorp's ownership of Family Guardian was inconsistent with the Board's regulation governing the activities of nonbanking subsidiaries of subsidiary banks. *See* 12 C.F.R. Sec. 225.22(d)(ii). It therefore held that "Family Guardian may not engage in insurance activities authorized under the Delaware statute other than those that are permissible under Section 4(c)(8) . . . ." Pet. App. 38a.

The Board explained that Citicorp's ownership of an insurance company violates the fundamental tenets of the

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[6] The petition filed with the Federal Reserve Board specifically contended that the indirect ownership of an insurance entity by a bank holding company violated (i) the Board's own, limited regulation governing the permissible activities of subsidiaries of banks, *see* 12 C.F.R. 225.22(d)(ii) (1990), (ii) the Board's earlier order barring Citicorp from acquiring a South Dakota bank as a means to enter the insurance business, *Citicorp (South Dakota)*, 71 Fed. Res. Bull. 789 (1985), and (iii) the plain language of the Act. Only the third ground forms a basis for this petition, because the Second Circuit's holding that the Act permits the challenged ownership was the basis for its conclusion that the Board lacks jurisdiction to prevent an indirect subsidiary's broad insurance activities.

[7] The transfer occurred on May 31, 1990, the day after the Delaware law was enacted. Pet. App. 23a. Citicorp's prior direct ownership of Family Guardian was lawful because the insurance company was underwriting only credit insurance. *See* 12 U.S.C. Sec. 1843(c)(8)(A). It is undisputed that Citicorp arranged the transfer so that Family Guardian could underwrite and sell broad forms of insurance that are otherwise impermissible under the Act.

Act and the policies it is designed to implement. Thus, the Board criticized "state initiatives that are designed to attract jobs and revenues to the state by allowing out-of-state banking organizations the ability to avoid federal banking policies by acquiring banks in the state that have the authority to export nonbanking activities not available to the organizations under federal law to the rest of the nation, but not to engage in these activities in the authorizing state itself." Pet. App. 27a. As the Board explained, "this type of initiative could promote potentially destructive competition among the states with adverse consequences for the national interest in safeguarding the safety and soundness of the nation's financial system and the federal deposit insurance funds." *Id.*[8]

Citicorp sought review of the Board Order in the Second Circuit. Reviewing the statutory language, the court agreed that "[t]here is no doubt that a literal application of this language would mean that Citicorp shall be deemed to own Family Guardian." Pet. App. 16a. Despite this seemingly conclusive statement, the court held that the Board's reading of the Act was "entirely untenable." Pet. App. 19a.

The court rested its disagreement with the Board on (i) lack of express legislative history indicating that Congress meant what it said (Pet. App. 17a), (ii) a provision of the Federal Reserve Act restricting loans by banks to their "affiliates" (Pet. App. 17a-18a), (iii) the court's view that the Act cannot be "sensibly" construed to apply to all nonbanking subsidiaries when it does not apply to the direct activities of subsidiary banks (Pet. App. 21a), and (iv) the fact that two other banking

[8] Governor Angell concurred, concluding that the plain language of the Act squarely applies to all nonbanking subsidiaries of a bank holding company. Pet. App. 42a. Governor Seeger also concurred, concluding that the Board should halt Citicorp's evasion of the insurance prohibition of the Act. Pet. App. 41a.

agencies, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, disagreed with the Board (Pet. App. 19a).

REASONS FOR GRANTING THE WRIT

I. THE AUTHORITY OF THE FEDERAL RESERVE BOARD TO CONTROL THE OWNERSHIP OF INSURANCE ENTITIES BY BANK HOLDING COMPANIES POSES A LEGAL QUESTION OF ENORMOUS NATIONAL IMPORTANCE

The practical impact of the Second Circuit decision is clear: Any bank holding company can avoid the limitations of the Bank Holding Company Act simply by using a state-chartered subsidiary bank as the means to buy an insurance company—or any nonbanking company authorized by permissive state law. That result would have enormous, deleterious consequences for the federal banking system, for the Federal Reserve System, for consumers and for these petitioners.

First, it is now commonplace to recognize that the economic upheaval of the early 1980s has begotten the solvency crises of the early 1990s. As a result of changing macroeconomic conditions, financial institutions embarked on a course of increased risk—increased risk that was intended to yield higher returns for customers. That risk proved too great.

The failure of the savings & loan industry, the virtual insolvency of the Federal Deposit Insurance fund and the more recent tremors in the insurance industry are far from localized failures. Difficulties in the financial sector can cause a run on the bank (or insurance company) and can cause systemic threats to affiliated companies.

The mixture of banking and insurance is a dangerous brew. Indeed, recent events have underscored the risks inherent in the insurance business. This year alone has seen the much-publicized demise of the First Executive Corp., First Capital Holdings Corp. and Monarch Capital Corp. Only a few months ago, Mutual Benefit Life

Insurance Co. was seized by New Jersey insurance regulators in order to stem a run on the company by panicked policyholders. *See Wall Street Journal*, July 15, 1991, at p. A3, col. 2.

To this would be added the current instability of our banking system. Earlier this year, Citicorp sustained an 83 percent drop in the net income for the second quarter. *See Wall Street Journal*, July 17, 1991, at p. A2, col. 2. Ironically, part of Citicorp's plunge in earnings stems from a $48 million loss from the sale of much of its stake in a specialized insurance company. More recently, the Chairman of a House Committee questioned whether Citicorp itself was still solvent. McCrady, *What If Citicorp Simply Agreed With Dingell*?, American Banker, Sept. 11, 1991, at 4; American Banker, Aug. 1, 1991, at 1.

The danger of combining weak banks with the uncertainties of insurance underwriting was recognized by the Board itself: "[T]his type of initiative could promote potentially destructive competition among the states with adverse consequences for the national interest in safeguarding the safety and soundness of the nation's financial system and the federal deposit insurance funds." Pet. App. 27a. And even that dire prediction fails to gauge the full import of the Second Circuit decision. By ruling that the Board lacks jurisdiction over the ownership of a class of nonbanking subsidiaries, the court permits bank holding companies to acquire any sort of company permitted by state law: real estate developers, securities underwriters, and amusement parks, to name but a few.[9] All the holding companies need do to escape the Board's oversight and control is to structure the corporate organization so that the nonbanking entity is a subsidiary of a bank.

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[9] *See* V. Saulsbury, *State Banking Powers: Where Are We Now?*, FDIC Regulatory Review (April/March 1987); Federal Reserve Board Docket No. R-0652 (comments of New Jersey Bankers Association noting permissibility in New Jersey of bank investment in amusement parks).

Second, the Board—as overseer of the Nation's commercial banking strength—has its own interest in protecting against a destructive race among states to authorize new, and more dangerous, investments for banks. The banks may be chartered by a state, but their failure is of national concern. When the solvency of bank holding companies is threatened, it is inevitably the Board that supplies short-term support through its discount window, safeguards liquidity through its control of monetary policy and, as lender of last resort, steps into rescue a failing institution. When Continental Illinois, a large Chicago bank holding company, was threatened with failure in 1984, it was the Board that stepped in with $3.6 billion to avert a banking crisis. Weiner, *A Chronology of Continental's Many Woes*, American Banker, May 18, 1984, at 3. When the stock market crashed in 1987, it was the Chairman of the Federal Reserve Board who announced that the Board would head off any liquidity crisis. *The Reuter Business Report*, Nov. 27, 1987.

The importance—and danger—of the decision below is this: It shackles the Board in the early going, when disaster could be averted, while leaving the Board responsible for picking up the pieces later on. The court's failure to comprehend the full scope of the Board's responsibility for safeguarding the solvency of our banking system led it to give short shrift to the Board's need to prevent—and not just repair—financial catastrophe.

Third, consumer interests could be slighted by permitting states to take over the job of deciding whether bank holding companies can underwrite and sell insurance and engage in other nonbanking activities. As this Court has recognized, the prime purpose of the Bank Holding Company Act is "to implement a congressional policy against control of a banking and nonbanking enterprise by a single business entity." *Lewis v. BT Inv. Managers, Inc.*, 447 U.S. 27, 46 (1980). That policy is designed to protect bank customers who might otherwise fear offending a prospective lender by refusing to purchase insurance from the bank, and to ensure that lenders are

neutral parties, whose credit judgment—essential to many small businesses and individual consumers—cannot be clouded by extraneous matters. H.R. Rep. No. 609, 84th Cong., 1st Sess. 4-5, 11, 16 (1955); S. Rep. No. 1095, 84th Cong., 2d Sess., pt. 1, 5; pt. 2, 2 (1956). It also ensures that customers cannot confuse FDIC-insured products with the separate business of an insurance underwriter.

The threat to consumers is not conjectural. Credit insurance is a classic example because it is a type of insurance that banks have traditionally been permitted to sell. *See* 12 U.S.C. Sec. 1843(c)(8)(A). Unfair tactics by sellers of credit insurance are estimated to cost consumers almost $1 billion each year.[10] Research conducted by the Board revealed that between one-sixth and one-fourth of all credit insurance sales have been coerced.[11] Yet these concerns may be of little importance to a state whose initiative is "designed to attract jobs and revenue" by authorizing mostly out-of-state activities. Pet. App. 27a.

Finally, vital interests of the insurance industry are threatened by the Second Circuit decision. State insurance guaranty funds are almost exclusively funded through assessments that follow an insurance failure. Thus, if an insurance company were to fail because of the weakness of its parent bank holding company, it would be other insurance companies, with no ties to the banking industry, who would be forced to replenish the state fund. And insurance agents would be separately exposed to the unfair competitive tactics of banks, which can use their lending business to leverage insurance sales and can use deposi-

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[10] *Credit Life Insurance, The Nation's Worst Insurance Ripoff*, Consumer Federation of America and National Insurance Consumer Federation (June 4, 1990).

[11] Robert A. Eisenbeis and Paul R. Schweitzer, *A Study of Ties Between the Granting of Credit and Sales of Insurance by Bank Holding Companies and Other Lenders*, Federal Reserve Board Staff Study (Oct. 1978).

tors' money as a cheap source of capital with which to expand into the insurance business.

* * * * * *

In sum, the dangers threatened by the Second Circuit decision are substantial and real. The decision, if not reviewed, is certain to precipitate dramatic changes in the banking-insurance industry. Because Petitioners are the most interested parties on the scene and will likely be precluded from bringing another suit, there is no real chance that any other circuit will have the opportunity to re-visit this question. These extraordinary circumstances necessitate this Court's review of the Second Circuit's momentus decision.

II. THE SECOND CIRCUIT INTERPRETATION IS PLAINLY WRONG

As the Second Circuit forthrightly conceded: "There is no doubt that a literal application of this language would mean that Citicorp shall be deemed to own Family Guardian." Pet. App. 41a. And that would indisputably mean that Family Guardian cannot underwrite and sell broad forms of insurance.

Section 4(a) of the Bank Holding Company Act provides that, without Board approval, no bank holding company may acquire or retain "direct or indirect ownership or control of any voting shares of any company which is not a bank." 12 U.S.C. Secs. 1843(a)(1). Section 4(c)(8) applies this limitation specifically to insurance by providing, with exceptions not relevant here, that bank holding companies may not underwrite or sell insurance. 12 U.S.C. Sec. 1843(c)(8). Family Guardian indisputably is not a bank; it is an insurance company. Furthermore, Section 2(g)(1) of the Act provides that "shares owned or controlled by *any* subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company." *Id.* Sec. 1841(g)(1) (emphasis added). Read together, Sections 4(a) and 2(g)(1) establish in clear and unambiguous terms that the Board has jurisdiction over Citicorp's acquisition and retention of indirect ownership and control of Family Guardian. That

is, as this Court has said, "the end of the matter." *Chevron U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984). *Accord Burlington Northern R. Co. v. Oklahoma Tax Comm'n*, 481 U.S. 454, 461 (1987).

Despite the absolute clarity of the statutory text, the Court of Appeals embarked on an exegesis of the legislative history of the Act. The court concluded that because the enactment of Section 2(g)(1) in 1966 was "noncontroversial" and "technical" in nature, there is no reason to think that Congress specifically intended to give the Board authority over bank subsidiaries. The court speculated that if Congress had intended the statutory text to be interpreted literally, then other bank regulators "surely would have objected." Pet. App. 17a. But such silence cannot give a contrary meaning to unambiguous statutory language. *See Harrison v. PPG Industries*, 446 U.S. 578, 592 (1980) ("In ascertaining the meaning of a statute, a court cannot, in the manner of Sherlock Holmes, pursue the theory of the dog that did not bark"); *Standefer v. United States*, 447 U.S. 10, 20 n.12 (1980) (rejecting a similar argument that "would permit an omission in the legislative history to nullify the plain meaning of the statute").[12]

More than anything else, the Second Circuit was troubled by the alleged inconsistency between the Board's position in the earlier *Merchants II* litigation and its position here. In *Merchants II*, the Board had urged the Second Circuit to rule that it lacked jurisdiction over the *direct* activities of holding company subsidiary banks, and the Second Circuit had agreed. The lower court was obviously troubled by the notion that the activities of the bank were free from Board control, but the activities of the bank's nonbanking subsidiary were not.

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[12] Similarly, the court erred in believing that an amendment to the Federal Reserve Act can alter the unmistakable language of the Bank Holding Company Act absent evidence that Congress specifically intended the two to operate in unison.

But in the prior case the Second Circuit itself had supplied the correct analysis, noting that a distinction between the activities of banks and the activities of nonbanking companies, even if owned by a bank, "would not be the first time that Congress has adjusted the competing positions of strong forces with a compromise of imperfect symmetry." *Merchants II*, 890 F.2d at 1282. After all, Congress had to draw the line between banking and commerce somewhere. It could rationally focus its attention on companies (rather than activities), and conclude that all nonbanking companies owned by bank holding companies should be subject to federal oversight while subsidiary banks were likely to stick to their knitting. It may have believed, in other words, that no bank itself would be able to engage directly in massive insurance underwriting and sales activities and that, therefore, the federal opposition to "control of a banking and nonbanking enterprise by a single business entity," *Lewis v. BT Inv. Managers*, 447 U.S. at 46, would be vindicated so long as all nonbanking companies were subject to the Act. The fact that the court indulged in legislative mind-reading to reach a different conclusion reinforces the basic point: The Second Circuit should have followed the express language of the statute and, as we explain briefly below, the considered opinion of the Board.

III. THE SECOND CIRCUIT FAILED TO APPLY THIS COURT'S SEMINAL RULING IN *CHEVRON*

Putting aside the Court of Appeals' troublesome refusal to follow the plain meaning of the statutory text, the *most* that can be said of the court's observations is that Congress has not "directly spoken to the precise question at issue." *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. at 842. *Chevron* teaches that when a statute is ambiguous, however, courts must defer to any reasonable interpretation by the agency charged with administration of the statute. Nevertheless, the Second Circuit refused to defer to the Board's con-

struction of the Bank Holding Company Act, finding the Board's view to be "perplexing" and not "sensibl[e]." Pet. App. 19a, 21a. That ruling is directly contrary to the precedent of this Court.

The Second Circuit's refusal to defer to the Board's well-reasoned construction of the Bank Holding Company Act, which is squarely supported by the statutory text, lays the seeds for sharply increased judicial second-guessing of agencies' interpretations of statutes they administer. Indeed, it is impossible to reconcile the Second Circuit's decision in this case with its approval of the Board's approach in *Merchants II*. Although professing in that case to respect the Board's interpretation of the Bank Holding Company Act, the Second Circuit actually has chosen to accept only half of the Board's interpretation. To honor only half of the Board's view, however, is to defer to none of it.

Moreover, the Second Circuit's reliance upon the competing views of other agencies undercuts the deference to which the Board is entitled under *Chevron*, and sharply curtails the government's ability to speak with one voice. *See Martin v. Occupational Safety and Health Review Comm.*, —— U.S. ——, 111 S. Ct. 1171 (1991) (when agencies' interpretations of regulation conflict, courts must defer only to interpretation of agency that enforces regulation); *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411, 419 (1965) (it is the "exclusive function of the Board" to rule on bank holding company arrangements).[13]

In any event, the court's logic is not even internally consistent. In congressional testimony in 1970, the Comptroller expressly agreed with the Board's interpretation of the statutory text. Comptroller Camp testified that

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[13] *Cf. Pension Ben. Guaranty Corp. v. LTV Corp.*, —— U.S. ——, 110 S. Ct. 2668, 2675-76 (1990) (in reaching decision under its organic statute, agency was not required to consider and honor policies and goals of other areas of law).

"[t]here is no legal doubt that any acquisition by the national bank subsidiary would be an 'indirect' acquisition by the [bank holding company]." *One-Bank Holding Company Legislation of 1970: Hearings Before the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 198 (1970) (Statement of William B. Camp). It is the Comptroller who, in this case, failed to follow his own prior interpretation of the law, a factor that would undermine that view even if it were relevant.

CONCLUSION

For all the foregoing reasons, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 953—August Term 1990

Argued: February 7, 1991 Decided: June 10, 1991

Docket No. 90-4124

CITICORP,

Petitioner,

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Respondent,

AMERICAN COUNCIL OF LIFE INSURANCE, INDEPENDENT INSURANCE AGENTS OF AMERICA, INC., NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, INC., NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS, PROFESSIONAL INSURANCE AGENTS OF PENNSYLVANIA, MARYLAND, AND DELAWARE, INC., INDEPENDENT INSURANCE AGENTS OF DELAWARE, DELAWARE ASSOCIATION OF LIFE UNDERWRITERS, STATE OF DELAWARE, and DELAWARE BANKERS ASSOCIATION,
Intervenors.

Before: LUMBARD, NEWMAN, and ALTIMARI, *Circuit Judges.*

Petition for review of the respondent's September 5, 1990, order prohibiting the subsidiary of a state-chartered bank owned by a bank holding company from engaging in insurance activities authorized by state law.

Petition for review granted; order of Board vacated.

Michael S. Helfer, Wash., D.C. (David S. Swayze, Joseph A. Fillip, Jr., Wilmington, Del.; Carl T. Solberg, New York, N.Y.; George G. Baxter, III, Alan F. Liebowitz, New York, N.Y.; Christopher R. Lipsett, Murray A. Indick, Wilmer, Cutler & Pickering, Wash., D.C., on the brief), for petitioner.

Jacob M. Lewis, Civ. Div., Dept. of Justice, Wash., D.C. (Stuart M. Gerson, Asst. Atty. Gen., Anthony J. Steinmeyer, Civ. Div., Dept. of Justice, Wash., D.C.; J. Virgil Mattingly, Gen. Coun., Richard M. Ashton, Assoc. Gen. Coun., Katherine H. Wheatley, Federal Reserve Board, Wash., D.C., on the brief), for respondent.

A. Gilchrist Sparks, III, Wilmington, Del. (Michael Houghton, S. David Peress, Morris, Nichols, Arsht & Tunnell, Wilmington, Del., and Marsha Kramarck, Deputy Atty. Gen., Wilmington, Del., on the brief), for intervenors Delaware Bankers Ass'n and State of Delaware.

David Overlock Stewart, Wash., D.C. (Martin E. Lybecker, Alan G. Priest, Raymond C. Ortman, Jr., Ropes & Gray, Wash., D.C., on the brief), for intervenor American Council of Life Insurance.

Jonathan B. Sallet, Wash., D.C. (Ann M. Kappler, Jenner & Block, Wash., D.C., on the brief), for remaining intervenors.

(John L. Warden, H. Rodgin Cohen, Lisamichelle Davis, Sullivan & Cromwell, New York, N.Y. submitted a brief for amicus curiae New York Clearing House Ass'n.)

(John D. Hawke, Jr., Melaine L. Fein, Pauline B. Heller, David F. Freeman, Jr., Arnold & Porter, Wash., D.C. submitted a brief for amicus curiae Conference of State Bank Supervisors.)

(John J. Gill, Michael F. Crotty, Amer. Bankers Ass'n, Wash., D.C.; James T. McIntyre, Jr., McNair Law Firm, Wash., D.C., Richard M. Whiting, Ass'n of Bank Holding Cos., Wash., D.C.; Wendy B. Samuel, David E. Danovitch, Charlotte M. Bahin, Natl. Council of Savings Institutions, Wash., D.C.; Marcia Z. Sullivan, Consumer Bankers Ass'n, Arlington, Va.; and Lawrence R. Uhlick, Institute of Int'l Bankers, New York, N.Y., submitted a brief for amici curiae Amer. Bankers Ass'n, Ass'n of Bank Holding Companies, Ass'n of Reserve City Bankers, Consumer Bankers Ass'n of Banks in Insurance Institute of Int'l Bankers, and National Council of Savings Institutions.)

JON O. NEWMAN, *Circuit Judge*:

Once again we consider an aspect of the broad issue of the extent to which banks are authorized to engage in nonbanking activities. That issue was before us just two years ago in *Independent Insurance Agents of America, Inc. v. Board of Governors*, 890 F.2d 1275 (2d Cir. 1989) (*Merchants II*), *cert. denied*, 111 S. Ct. 44 (1990). We there ruled, in agreement with the Federal Reserve Board ("the Board" or "the Fed"), that the Bank Holding Company Act ("BHCA" or "the Act") did not preclude bank subsidiaries of a bank holding company from selling insurance. The question now before us is the one left open in *Merchants II*—whether the BHCA extends the regulatory authority of the Fed to the subsidiary of a holding company's bank subsidiary.

The question arises on a petition for review filed by Citicorp challenging the Board's September 5, 1990, order. That order requires one of Citicorp's bank subsidiaries, Citibank Delaware, to terminate insurance ac-

tivities that the bank subsidiary was conducting through its operating subsidiary, Family Guardian Life Insurance Co. ("Family Guardian"). Though mindful of the deference due an agency's construction of the statute it is administering, we conclude that, once the BHCA has been construed to leave the regulation of a holding company's subsidiary banks to their chartering authorities, the Act cannot sensibly be interpreted to reimpose the authority of the Fed on a generation-skipping basis to regulate the subsidiary's subsidiary. We therefore grant the petition for review and vacate the Board's order.

Background

Before introducing the facts, it will be helpful to outline briefly the pertinent statutory provisions of the BHCA, the construction placed on those provisions at the Board's urging by this Court in *Merchants II*, the Board's regulation concerning operating subsidiaries, and the pertinent aspects of the Delaware regulatory framework.

The Statutory Framework. The principal regulatory powers of the Fed concerning bank holding companies are set forth in sections 3 and 4 of the Act. 12 U.S.C. §§ 1842, 1843 (1988). Section 3 requires Board approval of the acquisition of ownership or control of any bank by a bank holding company, with narrow exceptions not here relevant. Section 3 sets forth factors governing acquisition approval, focusing on the competitive effect of the proposed acquisition, the financial and managerial resources of both the holding company and the acquired bank, and the convenience and needs of the community served. *Id.* § 1842(c).

Section 4 of the Act, the provision ultimately at issue in this litigation, contains two sets of prohibitions. First, it specifies, in what might be called the "ownership clause," that a bank holding company may not "retain direct or indirect ownership or control of any voting shares of any company which is not a bank or bank hold-

ing company." *Id.* § 1843(a)(2). Second, it provides, in what might be called the "activities clause," that a bank holding company may not "engage in any activities other than (A) those of banking or of managing or controlling banks . . . and (B) those permitted under [section 4(c)(8) of the Act] . . . ." *Id.* Section 4(c)(8) sets forth the so-called "closely related to banking" exception to the nonbanking prohibition of the ownership and activities clauses. In relevant part, section 4(c)(8) states that the section 4(a) nonbanking prohibitions shall not apply to

> shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto, but for purposes of this subsection it is not closely related to banking or managing or controlling banks for a bank holding company to provide insurance as a principal, agent or broker . . . .

Id.

The Decision in Merchants II. In 1989 the Board approved an application by Merchants National Corporation, a bank holding company, to permit two of its Indiana bank subsidiaries to engage in insurance activities. *Merchants National Corp.*, 75 Fed. Res. Bull. 388 (1989). That ruling was vigorously challenged in this Court by insurance interests who contended that the BHCA was intended to accomplish a nearly complete separation of banking and nonbanking activities by precluding bank holding companies and all entities within their systems from engaging in nonbanking activities, other than the "closely related to banking" activities specifically identified in section 4(c)(8) of the Act. The Board took the position that Congress had not gone so far. In the Board's view, Congress had precluded nonbanking activities by bank holding companies themselves

but had not wished to displace the traditional authority of state and national bank chartering bodies to determine what nonbanking activities could appropriately be engaged in by banks that are subject to their regulatory authority, even though such banks were owned by a bank holding company under the jurisdiction of the Fed.

The dispute between the Board and the banking interests, on the one hand, and the insurance interests, on the other hand, was a substantial one. Ultimately, we ruled in favor of the Board. *Merchants II*, 890 F.2d at 1284. We acknowledged that the statute was not entirely clear and that arguments supporting each of the contending positions could plausibly be based on some of the language of the Act, some aspects of the structure of the Act, and some passages from the legislative history. *Id.* at 1281-84. After canvassing the available evidence, we concluded that the construction urged by the Board was a "reasonable interpretation" of the Act, "one that confides decisions concerning the scope of insurance and other nonbank activities of bank subsidiaries to their national and state chartering authorities." *Id.* at 1284.

In *Merchants II* we noted the Board's additional position that, although the Act denied the Board authority to preclude bank subsidiaries of a bank holding company from engaging in nonbank activities, it nonetheless empowered the Board to preclude the subsidiaries of bank subsidiaries from engaging in nonbank activities. Though the insurance interests pressed upon us the "apparent awkwardness and perhaps illogic," *id.* at 1282, of the Board's generation-skipping approach, we confined our ruling to approval of the Board's construction of the Act to permit nonbank activities by bank subsidiaries (the first generation after the holding company), and left for another day the issue of whether the Act could simultaneously be construed to bar nonbank activities by a

subsidiary's subsidiaries (the second generation). That day has now arrived.

The Board's Operating Subsidiary Rule. Long before the administrative and judicial rulings in *Merchants II*, the Board had issued Regulation Y, the so-called "operating subsidiary rule," which purports to govern the activities of subsidiaries of a bank holding company. *See* 12 C.F.R. Pt. 225 (1990) (current version). In general, such subsidiaries must limit their activities to those banking and "closely related to banking" activities permitted by section 4 of the Act. However, one provision of Regulation Y permits state-chartered banks, without the Board's prior approval, to acquire

> all . . . of the securities of a company that engages solely in activities in which the parent bank may engage, at locations at which the bank may engage in the activity, and subject to the same limitations *as if the bank were engaging in the activity directly.*

Id. § 225.22(d)(2)(ii) (emphasis added). Thus, under Regulation Y and the Board's construction of section 4, as endorsed in *Merchants II*, a subsidiary of a state-chartered bank subsidiary of a holding company may engage in nonbank activities permitted to the bank under state law, provided that the activities are conducted under the same limitations that would apply if the bank were engaging in the activities "directly." [1]

The Delaware Regulatory Framework. In May 1990, Delaware enacted the Bank and Trust Company Insurance Powers Act of 1989, 67 Del. Laws, c. 223 (1990) ("the Delaware statute"). The Delaware statute permits Delaware banks, under certain conditions, to engage in insurance activities (other than title insurance). The statute affords the banks the option of conducting insurance activities through a "department" or "division" of

[1] A comparable regulation applies to operating subsidiaries of national banks. 12 C.F.R. § 225.22(d)(1) (1990).

the bank or through a subsidiary of the bank. Whichever option is chosen, the statute requires substantial structural barriers between the bank's insurance activities and its banking activities.

For example, the statute requires that the assets of the bank may be applied only to satisfy the non-insurance liabilities of the bank and not those of the bank's insurance "division," *id.* § 8, and the assets of the insurance "division" may be applied only to satisfy the liabilities of that "division" and not the other liabilities of the bank, *id.* § 22. The statute places a 25 percent limit on the amount of the bank's total capital, surplus, and undivided profits that may be allocated to its insurance "division," *id.* § 10, and the minimum capital that the bank is required to maintain under Delaware banking law may not be used to meet the separate capital requirements of the "division" imposed by state insurance law, *id.* § 3. The statute provides that for purposes of the Delaware Insurance Code an insurance "division" of a bank is treated as an insurance company "in the same manner and to the same extent as if it were a separately incorporated subsidiary . . . with separate capital accounts, assets and liabilities." *Id.* § 17.

In general, Delaware authorizes its bank commissioner to regulate the banking activities of state-chartered banks and authorizes its insurance commissioner to regulate the insurance activities of a bank's insurance "division." *Id.* §§ 5, 38. However, the statute permits the bank commissioner to supervise the insurance "division" whenever he determines that the "division's" activities are "likely to have a materially adverse effect on the safety and soundness of the bank." *Id.* § 5.

Citicorp's Banking and Insurance Activities in Delaware. Citicorp is a bank holding company with assets of more than $200 billion. In 1982, Citicorp obtained a charter from Delaware for Citibank Delaware, a commercial bank wholly owned by Citicorp. Citibank Dela-

ware has assets of more than $2 billion and serves customers in 35 states.

In 1986, with the approval of the Fed, Citicorp established Family Guardian as a wholly owned subsidiary to underwrite and sell certain credit-related insurance expressly authorized for bank holding companies by section 4(c)(8)(A) of the BHCA, 12 U.S.C. § 1843(c)(8)(A). The day after the Delaware statute was enacted, Citicorp transferred all of the voting shares of Family Guardian to Citibank Delaware in order to permit Family Guardian to transact the broader range of insurance activities authorized under the Delaware statute for insurance "divisions" and subsidiaries of Delaware banks. Family Guardian then began to expand its operations to include insurance underwriting and other insurance activities within the scope of Delaware law, though beyond the scope of the "closely related to banking" activities specified in section 4(c)(8) of the BHCA.

The Pending Litigation. Soon after the expansion of Family Guardian's insurance activities, various insurance industry trade associations filed a petition with the Board, contending that Family Guardian's activities were not permitted under the operating subsidiary rule of Regulation Y. The complainants argued that the barriers required by the Delaware statute between the banking and insurance activities of a Delaware-chartered bank were so substantial that a Delaware bank, such as Citicorp Delaware, could not engage in insurance activities "directly" within the meaning of Regulation Y. Since Citicorp Delaware could not engage in these insurance activities "directly," the argument continued, its subsidiary, Family Guardian, was not operating within the limitations of Regulation Y.

The Fed accepted the contentions of the complainants, ruled that the activities of Family Guardian were not authorized by Regulation Y, and concluded that these activities, if not exempted by Regulation Y, were im-

permissible under the BHCA for an entity owned by a subsidiary of a subsidiary of a bank holding company. *Citicorp*, 76 Fed. Res. Bull. 977 (1990). The Board ordered Citicorp to cause Family Guardian to cease providing any insurance activities beyond those authorized and approved by the Board under section 4(c)(8)(A). Citicorp then brought this petition for review to challenge the Board's ruling.

Discussion

Citicorp makes two arguments. First, it contends that the insurance activities of Family Guardian are permitted for the bank subsidiary of Citicorp by virtue of the Board's operating subsidiary rule. Second it contends that, if the operating subsidiary rule does not permit insurance activities by Family Guardian, the Board lacks statutory authority under the BHCA to proscribe the activities of a subsidiary of a holding company's bank subsidiary.

1. Citicorp's Claim under Regulation Y.

Regulation Y, as we have noted, permits state-chartered banks to own a subsidiary company "that engages solely in activities in which the parent bank may engage . . . and subject to the same limitations as if the bank were engaging in the activities directly." 12 C.F.R. § 225.22 (d)(2)(ii). Citicorp contends that the Delaware statute permits a Delaware-chartered bank, like Citicorp Delaware, to sell insurance and leaves it up to the bank whether to operate its insurance activity in a "division" within the bank or in a wholly owned subsidiary of the bank. With that proposition the Fed is in agreement. The dispute concerns the meaning of "directly" in Regulation Y. The Fed takes the position that the extent of separation between a bank and its insurance "division" required by the Delaware statute has the effect of precluding the bank from "directly" engaging in the insur-

ance activities of its "division." Since, in the Fed's view, the bank could not engage in insurance activities "directly" within the bank, Regulation Y does not permit it to do so through an operating subsidiary. Citicorp contends that the separateness of an insurance "division," required by Delaware law, does not prevent the bank from engaging in insurance activities "directly."

Citicorp devotes much of its argument on this aspect of the appeal to a detailed analysis of the Delaware statute, an analysis that the Fed does not dispute. As both sides recognize, Delaware clearly permits a Delaware-chartered bank to engage in insurance activities through a "division" located within the bank and just as clearly imposes a host of restrictions designed to achieve a degree of separation between the insurance activities of the bank's insurance "division" and the other activities of the bank. Whether the resulting separation precludes a bank from engaging in insurance activities "directly" within the meaning of Regulation Y is an issue of federal law, not Delaware law.

It would be a straightforward interpretation of Regulation Y to read it to mean that a bank may own a nonbanking subsidiary so long as the subsidiary is subject to the same limitations that would apply if the activities of the subsidiary were being conducted within the bank itself. Under this reading "directly" would simply mean "within the bank," as distinguished from "through a subsidiary." Indeed, in the BHCA the adverb "directly" is used in this sense. *See* 12 U.S.C. § 1842(f)(1) (referring to activities in which a qualified savings bank may "engage, directly or through a subsidiary"); *id.* U.S.C. § 1843(a)(2) (referring to activities in which a bank holding company may be engaged "directly or through a subsidiary"). The Fed's reading, however, gives "directly" substantive content, interpreting it to mean that the bank must engage in the activity not only "within the bank" but in the absence of the degree of separate-

ness mandated by the Delaware statute for a bank's insurance "division."

We confess to considerable wonderment as to why the Fed would want to construe its regulation to mean that insurance activities conducted in a "division" of a bank are not conducted by a bank "directly" just because the "division" is surrounded by protections designed to maintain the soundness of both the banking and the insurance activities of the bank. It is not readily apparent why the Fed would be *more* willing to permit Citibank Delaware to sell insurance if Delaware provided *less* protection for the bank's assets from the risks of the bank's insurance activities.

Moreover, the Fed's reading of its regulation puts considerable strain on the word "limitations" in Regulation Y. That word would sensibly apply to any requirement that a state imposes on a bank's operating subsidiary. For example, if a state were to require the insurance subsidiary of a bank to maintain a specified amount of capital, unencumbered by liabilities arising from the parent's banking business, it would surely make sense to read Regulation Y to mean that the bank must maintain that same amount of capital, equally unencumbered, in its insurance "division" if the bank chooses to sell insurance through a "division" within the bank, rather than through a subsidiary. But the separateness required by Delaware law is a different sort of "limitation." It is structural in nature, requiring the insurance "division" and its assets and liabilities to maintain some degree of distinction from the other activities of the bank.

A further cause for concern about the Fed's position is the response of its General Counsel to a specific inquiry from a member of the Delaware House of Representatives during consideration of the bill that became the Delaware statute. The inquiry sought advice as to the significance, for federal regulatory purposes, of the

extent of separation between an insurance "division" and the rest of a bank's activities. The General Counsel replied that under the proposed statute, Delaware banks may conduct broadened insurance activities "*directly within the bank* or in a separate subsidiary of the bank" and noted that, under the Board's operating subsidiary rule, "if a holding company state bank is permitted to conduct an activity *directly*, the bank may establish a wholly-owned nonbank subsidiary to conduct the activity." Letter of J. Virgil Mattingly, Jr., to the Honorable John F. Van Sant (May 17, 1989) (emphasis added).

The Board's treatment of this letter is troublesome. Its brief first points out that the inquiry suggests that the Delaware legislature "was aware of the problems the proposed statute might engender under [the BHCA]." Brief for Respondent at 25. Presumably, the legislator, though "aware of the problems," thought he had gotten an authoritative assurance that the separateness did not preclude the bank from engaging in insurance activities "directly." Not so, says the Board, suggesting that the General Counsel's first use of the adverb "directly" was just a "summary description" of the bill and "not a substantive determination of the scope of the Board's operating subsidiary rule (which was not mentioned until the bottom of the letter's next page)." *Id.* at 25 n.10. Surely the inquiring legislator was entitled to think that the General Counsel understood that "directly" was a term of art and that he was not using the term colloquially on page one and technically on page two. Finally, the Board makes the point that the General Counsel's views are "not a determination by the Board." *Id.* at 25.

Despite our considerable unease at the way the Board is construing the word "directly" in its regulation, especially in light of the advice its General Counsel furnished to the Delaware legislature, we are willing to assume, for purposes of this appeal, that the separation mandated by the Delaware statute precludes a bank from operating its insurance "division" "directly." So

long as the Board is exercising its statutory authority, it has ample discretion to frame regulations and accord to its chosen words any technical meaning it wishes that does not purport to deny those words any semblance of their ordinary meaning. *See United States v. Larionoff*, 431 U.S. 864, 872-73 (1977); *Soler v. G & U Inc.*, 833 F.2d 1104, 1108 (2d Cir. 1987), *cert. denied*, 488 U.S. 832 (1988). In this instance, the Board's view that a separate insurance "division" is not being operated "directly" by a bank presses that rule to its limit, and possibly beyond, but we will assume that the Board has fairly interpreted its own regulation and proceed to consider the statutory issue.

2. Citicorp's Claim under the BHCA.

Citicorp contends that the BHCA does not permit the Fed to regulate the activities of the subsidiary of a bank subsidiary of a holding company. Before the *Merchants II* litigation, that contention would have posed a substantial issue because a major controversy then existed as to whether the BHCA permitted non-banking activities (other than those specifically authorized by section 4(c)(8)) to be conducted anywhere in a system controlled by a bank holding company. The insurance interests in *Merchants II* contended that neither a holding company, nor a bank subsidiary, nor the subsidiary of a bank subsidiary could engage in nonbanking activities. However, the Fed disagreed with that interpretation of the Act and argued that the bank subsidiaries of a holding company were beyond the Board's regulatory authority. In the Fed's view, Congress intended to leave unimpaired the primary regulatory authority of state and national bank chartering agencies to determine the activities of institutions under their jurisdiction. We agreed with that construction of the statute.

Thus, in the aftermath of *Merchants II*, we take the Act as if it said in terms, "The Board is without au-

thority to limit the activities of a bank subsidiary of a bank holding company." Now the question is whether the Board may nonetheless regulate the activities of a bank subsidiary's subsidiary. The rationale of the position that the Board successfully urged upon us in *Merchants II* requires an answer consistent with the interpretation the Board there urged us to adopt. The Board urged, and we agreed, that Congress wanted bank chartering agencies to regulate the activities of banks within their jurisdiction. By virtue of their authority over the banks that they charter, those agencies have ample authority to determine the permissible activities of the subsidiaries owned by the banks. We have been given no reason to believe that Congress wanted the jurisdiction of bank chartering authorities to end at the corporate structure of the bank itself, rather than extend throughout the chain of companies owned by the bank. Surely a bank chartering agency, charged with the responsibility to maintain the soundness of a bank, is vitally interested in the assets owned by a bank, including shares of wholly owned subsidiaries. In the pending case, Delaware has demonstrated that its regulatory authority over Delaware-chartered banks is not confined to activities occurring within the bank, but extends to insurance activities whether conducted within the bank (albeit in a separate "division") or in a subsidiary of the bank.

Moreover, the Board has provided no basis for believing that Congress wished to create two classes of state-chartered banks—those owned and not owned by bank holding companies. Before *Merchants II*, such an argument was plausible; Congress might have wanted those state-chartered banks owned by holding companies to be confined to banking activities, leaving banks not so owned to have broader activity. But once the Board pursuaded us to read the statute to leave all state-chartered banks free to sell insurance, subject to state, not Board, regulation, there is no basis for believing that Congress simul-

taneously adopted a generation-skipping approach and authorized the Board to bar the subsidiaries of state-chartered banks from selling insurance whenever those banks were in turn the subsidiaries of a holding company.

Neither of the two technical statutory arguments tendered by the Board supports the generation-skipping approach. Section 4(a) of the Act provides that no bank holding company shall acquire or retain "direct or indirect ownership or control of any voting shares of any company which is not a bank." 12 U.S.C. § 1843(a)(1), (2). That provision would plainly bar a holding company from using some entity other than a bank to acquire or retain control of a nonbanking company. A holding company may not directly acquire an insurance company, and it may not do so indirectly through some shell corporation, voting trust, or other nonbanking entity. But section 4 and the entire BHCA obviously contemplate that a holding company may own a bank, and if the Act permits the bank to sell insurance, subject to state regulation, it leaves the states equally free to permit bank subsidiaries to sell insurance. That is made explicit in section 7 of the Act, which provides:

> No provision of this chapter shall be construed as preventing any State from exercising such powers and jurisdiction which it now has or may hereafter have with respect to . . . banks . . . and subsidiaries thereof.

12 U.S.C. § 1846.

The Board also relies on section 2(g)(1) of the Act, which provides that "shares owned or controlled by any subsidiary of a bank holding company shall be deemed to be indirectly owned or controlled by such bank holding company." 12 U.S.C. § 1841(g)(1). There is no doubt that a literal application of this language would mean that Citicorp shall be deemed to own Family Guardian.

But the question remains whether, in adding section 2(g)(1) in 1966, Congress intended to extend to the Board the authority to prevent a state-chartered bank like Citicorp Delaware from selling insurance through an operating subsidiary like Family Guardian. Citicorp contends, and we agree, that the purpose of section 2(g)(1) was to make clear that the BHCA applied when a holding company's *nonbank* subsidiaries controlled, but did not wholly own, another company. *See Amend the Bank Holding Company Act of 1956: Hearings on S. 2353, S. 2418 and H.R. 7371 Before a Subcomm. of the Senate Comm. on Banking and Currency, Pt. 1*, 89th Cong., 2d Sess. 342 (1966) ("Technical question[s] ha[s] arisen" regarding applicability of phrase to situation in which a bank holding company "owns less than 50% of the voting shares of" a company that owns another company). The 1966 amendment was non-controversial and elicited no opposition from national or state bank regulators who surely would have objected, as they do now, to the contention that the amendment permits the Fed, and not these chartering regulators, to determine what activities may be engaged in by the operating subsidiary of a bank subject to their jurisdiction.

Moreover, in the same bill that added section 2(g)(1), Congress amended section 23A of the Federal Reserve Act, 12 U.S.C. § 371c (1988) (current codification), to restrict loans by banks to their "affiliates" and incorporated subsidiary relationships of the BHCA. Act of July 1, 1966, Pub. L. No. 89-485, § 12(a), 80 Stat. 236, 241 (1966). Subsequently, the Board ruled that section 23A did not apply to loans made by a bank to its operating subsidiaries, *see* 12 C.F.R. § 250.240 (1990) (current version), and Congress codified the Board's interpretation, with an exception not relevant here, when it revised section 23A in 1982:

> the following shall not be considered to be an affiliate:

> (A) any company, other than a bank, that is a subsidiary of a member bank . . . .

12 U.S.C. § 371c(b)(2).

The Board responds to these contentions by assailing Citicorp for making the "assumption" that Family Guardian is an operating subsidiary of Citicorp Delaware. *See* Brief of Respondent at 30 n.13. The Board's point here is simply a reaffirmation of its interpretation of Regulation Y: since Citicorp Delaware may not operate Family Guardian "directly" within the bank, it may not operate it as a subsidiary. The argument is entirely unpersuasive on the statutory issue. Even if, as we have indulgently assumed, Regulation Y may plausibly be read to mean that Family Guardian is not the sort of operating subsidiary specifically authorized by that regulation, it cannot be maintained that Family Guardian is not in fact an operating subsidiary of Citibank Delaware. Obviously it is; it operates a business and it is wholly owned by Citicorp Delaware. The Board's strained interpretation of Regulation Y cannot answer the statutory issue of whether the BHCA permits the Board to regulate the activities of an entity that is demonstrably the operating subsidiary of a state-chartered bank.

The Fed reminds us that in *Merchants II* we contemplated the possibility that the Fed might be correct both in its view that the BHCA permitted a state-chartered bank subsidiary of a holding company to be immune from coverage of the BHCA and in its view that the Act nevertheless reached the subsidiary's subsidiary. We there observed that "*if* the Board is right [in both views], this would not be the first time that Congress has adjusted the competing positions of strong forces with a compromise of imperfect symmetry." 890 F.2d at 1282 (emphasis added) (citation omitted). But in *Merchants II*, we were required to decide only whether the Board was entitled to read the Act to leave the regulation of the nonbank activities of holding company banks to charter-

ing authorities. We were not obliged to endorse the Board's additional (and "perplexing," *id.*) view that the Act reached the subsidiary's subsidiary. The fact that we peered into the abyss of conflicting statutory constructions that occur in federal law and noted that in some instances they reflect political realities does not mean that we accepted both aspects of the Fed's views. In *Merchants II* we had to decide whether the possibility of an asymetrical construction of the BHCA precluded the view advanced by the Fed with respect to coverage of holding company banks, and we agreed with the Fed that it did not. Now we face the issue whether the Fed's view concerning BHCA coverage of the subsidiary's subsidiary is only a tolerable inconsistency or an entirely untenable construction, and we conclude it is the latter.

The conclusion we reach enjoys the support of the other two of the three bank regulating authorities of the nation, the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"). The Chairman of the FDIC advised the Fed in 1989, "In our view, subsidiaries of state banks are beyond the scope of the Bank Holding Company Act . . . ." Letter of L. William Seidman to Alan Greenspan, April 28, 1989. Similarly, the OCC informed the Fed, "[T]he Office of the Comptroller of the Currency (OCC) does not believe that the BHCA gives the FRB the authority to regulate or define permissible activities of state banks, whether conducted regularly or through subsidiaries." Letter of Dean S. Marriott to William W. Wiles, April 28, 1989. In neither instance were the views of these national bank regulators grudging disclaimers of desirable authority; on the contrary, both the FDIC and the OCC expressed the belief that leaving operating subsidiaries of state chartered banks subject to the regulating authority of state banking regulators, whether or not such banks were owned by bank holding companies, was both a sound construction of the BHCA and a desirable policy of bank regulation.

We recognize that courts are not obliged to defer to interpretations of a statute made by agencies not responsible for its administration, *see Dep't of Treasury v. Federal Labor Relations Authority*, 837 F.2d 1163, 1167 (D.C. Cir. 1988). It is the Fed, not the FDIC or the OCC, that administers the BHCA. Nevertheless, having reached the conclusion that the BHCA, in light of the construction previously urged upon us by the Fed, must be understood to leave the subsidiaries of state-chartered banks to state regulating authorities, we take some comfort in knowing that those with significant national responsibilities for maintaining a sound banking system share our view of the statute. We would surely be reluctant to read the Act to preclude coverage of subsidiaries of holding company banks in the face of unanimous views by national bank regulators that such a construction is bad law and bad policy. The disagreement among national banking regulators does not leave us free to adopt whatever construction seems best in our judgment. We are still obliged to begin our task by according deference to the view of the agency directly responsible for administering the Act. But when that view clashes with the construction of the statute that the same agency has urged us to adopt, we need not elevate deference to blind obeisance, and we can notice the contrary view of significant banking regulators.

In *Merchants II*, it is likely that we would have upheld the Board had it chosen to interpret the BHCA to bar nonbanking activities throughout a bank holding company's system, even though we ultimately agreed with the Board's interpretation that the Act permitted bank subsidiaries of holding companies to engage in nonbanking activities. As we acknowledged in *Merchants II*, the BHCA is not clear as to whether it requires bank holding companies and all subsidiaries within their systems to observe a total separation from nonbanking activities. But however that issue is resolved, the Act must be in-

terpreted as a whole and must retain some internal coherence. The Board ruled that whether bank subsidiaries may engage in nonbanking activities is a matter for the chartering authorities of those banks, and not for the Board. Once that decision was made, we cannot agree that the Act can sensibly be construed to permit the Board to displace bank-chartering authorities in determining what activities are permitted for the subsidiaries of bank subsidiaries.

The petition for review is granted, and the order of the Board is vacated.

APPENDIX B

FEDERAL RESERVE SYSTEM

Citicorp, New York, New York and Family Guardian Life Insurance Company, Phoenix, Arizona

Order with Respect to Petition for Enforcement

The Independent Insurance Agents of America, Inc.; National Association of Casualty & Surety Agents; National Association of Life Underwriters, Inc.; National Association of Professional Insurance Agents; National Association of Surety Bond Producers; Professional Insurance Agents of Pennsylvania, Maryland and Delaware, Inc.; and the Delaware Association of Life Underwriters ("Petitioners") have petitioned the Board to initiate enforcement action to require Citicorp, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), to terminate certain insurance activities conducted pursuant to a newly enacted Delaware statute by Family Guardian Life Insurance Company, Phoenix, Arizona ("Family Guardian"), an indirect nonbank subsidiary of Citicorp.[1] The petition contends that the broad insurance agency and underwriting activities authorized by the Delaware statute are not permissible for bank holding companies and their nonbank subsidiaries under section 4(c)(8) of the BHC Act, as amended by the Garn-St Germain Depository Institutions Act of 1982,[2] and are, therefore,

[1] The American Council of Life Insurance, the American Insurance Association, the National Association of Independent Insurers, and the Alliance of American Insurers have, by separate letter, joined in the petition for enforcement.

[2] 12 U.S.C. § 1843(c)(8). The Garn-St Germain Depository Institutions Act of 1982 amended section 4(c)(8) of the BHC Act to provide that it is not closely related to banking for a bank holding company to provide insurance as a principal, agent or broker except in seven specific situations.

not permissible for Family Guardian as a nonbank subsidiary of Citicorp under the Act.

Citicorp currently holds the shares of Family Guardian through Citibank (Delaware), New Castle, Delaware ("Citibank Delaware"), a state-chartered bank that is a wholly-owned subsidiary of Citicorp.[3] Citicorp originally established Family Guardian, with the required Board approval under the BHC Act, to underwrite and sell certain credit-related insurance expressly authorized for bank holding companies by section 4(c)(8)(A) of the BHC Act.[4] On May 31, 1990, Citicorp transferred the voting shares of Family Guardian to Citibank Delaware in order for Family Guardian to transact the broader range of insurance activities authorized under the Delaware statute which was enacted on May 30, 1990. The Delaware statute provides that state-chartered bank may act as an insurer and transact the business of insurance (other than title insurance) through a separate division of the bank or through a subsidiary of the bank.[5] After its transfer to Citibank Delaware, Family Guardian, with the approval of the Delaware Insurance Commissioner, began to expand the scope of its insurance activities to include insurance underwriting and agency functions that are not permissible for bank holding companies under section 4(c)(8) of the Act.[6]

[3] Citibank Delaware engages primarily in leasing and commercial lending activities, and had assets of approximately $1.8 billion as of March 31, 1990.

[4] 12 U.S.C. § 1843(c)(8)(A). The insurance activities of Family Guardian prior to its transfer to Citibank Delaware had been authorized by the Board under the first of the seven exceptions specified in the Garn-St Germain Act.

[5] House Bill No. 193, House Substitute No. 1 ("House Bill No. 193").

[6] As of March 31, 1990, Family Guardian had $203 million in assets and net contingent insurance liabilities outstanding of several billion dollars. At present, the expanded insurance activities of Family Guardian represent an insignificant percentage of its business.

Citicorp acquired Citibank Delaware pursuant to Delaware's Financial Center Development Act, which allows out-of-state bank holding companies to acquire newly chartered state banks in the state, subject to certain conditions. The banks acquired by out-of-state companies must employ at least 200 residents of Delaware after two years, may have only one branch open to the general public in Delaware, and may not market the bank's products and services in Delaware to the substantial detriment of existing Delaware banks, except to serve and retain existing customers.[7] Although the Delaware statute authorizes state-chartered banks to engage in the general insurance business on a nationwide basis through offices in any state, banks owned by out-of-state holding companies may not market the sale of insurance products in Delaware to the detriment of Delaware banks.[8]

In addition, the Delaware statute requires that the insurance activities must be conducted through a division or department of the bank that must be separately capitalized in accordance with the requirements of the Insurance Code, that must maintain financial records separate and distinct from the other records of the bank, and that must comply with an extensive series of structural, operational, and regulatory requirements designed to treat the insurance division as a distinct corporate entity separate from the bank.[9]

In their petition for enforcement, filed on May 30, 1990, Petitioners argue that Citicorp is not authorized to hold Family Guardian under the BHC Act once it expands its insurance activities beyond those authorized

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[7] Del. Code Ann. tit. 5, §§ 801-07.

[8] House Bill No. 193, Sections 2, 7; Senate Bill No. 415, Section 1, Letter, dated June 1, 1990, from Keith H. Ellis, Delaware State Bank Commissioner to Mr. Richard T. Collins, Vice President, Citicorp.

[9] House Bill No. 193, Sections 4-38.

and approved by the Board under section 4(c)(8) of the BHC Act. Petitioners contend that, as a nonbank subsidiary of the holding company, Family Guardian's continued ownership by Citicorp after commencement of the broad insurance activities authorized by the Delaware statute is not permitted under any of the nonbanking provisions of the BHC Act.

In this regard, Petitioners argue that Citicorp may not rely on the Board's existing regulatory exemption in Regulation Y for operating subsidiaries of holding company state banks as authority to retain control of Family Guardian through Citibank Delaware. The operating subsidiary rule states that a state-chartered bank owned by a bank holding company may acquire and retain, without Board approval under the BHC Act, all (but not less than all) of the shares of a company engaged solely in activities in which the parent bank may engage, subject to the same limitations that would apply if the bank were engaging in the activity directly.[19] 12 C.F.R. § 225.22(d)(ii). Petitioners argue that the Delaware statute does not in practice permit state banks to conduct insurance activities *directly* because the Delaware statute requires that the state bank conduct general insurance activities only through a division of the bank that has been separated in all material respects from the bank itself. Thus, Petitioners argue, holding company banks may not take advantage of the operating subsidiary rule to establish a subsidiary to conduct these activities.

In the alternative, Petitioners contend that the operating subsidiary regulation itself is inconsistent with the express terms of section 4 of the BHC Act because it permits holding companies to acquire and retain nonbank companies without compliance with the prior approval, activity, and prudential limits of section 4 of the Act.

[19] In addition, under the rule, the activities may be conducted only at locations at which the bank could conduct the activity.

On June 28, 1990, Citicorp responded to the arguments made in the petition for enforcement. Citicorp contends that Family Guardian's expanded insurance activities are permissible under the operating subsidiary rule in Regulation Y, since the Delaware statute on its face authorizes state-chartered banks to transact the business of insurance and since the requirement that insurance activities be conducted in a separate department is consistent with traditional regulatory practice.

The Board has carefully considered the submissions of Petitioners and Citicorp. As explained below, the Board concludes that the operating subsidiary rule does not authorize Citicorp to retain ownership and control of Family Guardian for purposes of the BHC Act to the extent that Family Guardian takes advantage of the Delaware statute to expand its insurance activities beyond those permissible for bank holding companies and their nonbank subsidiaries under section 4(c)(8) of the Act. Although on its face the Delaware statute authorizes state-chartered banks to provide a full range of insurance services, the Board cannot ignore the fact that this authorization is conditioned on compliance with an unprecedented and comprehensive set of regulatory restrictions, the practical effect of which is to treat the insurance division as a separate corporate entity. For example, the separation has been carried to such an extent that the routine authority of the state bank regulator over the insurance division is restricted, and the insurance division is regulated under the insurance laws as a separate corporate entity from the bank. Thus, in the Board's view, the Delaware statute does not authorize banks to engage in the insurance business directly, as is required by the operating subsidiary rule.

The Board emphasizes that its decision in this case is not based on the view that banking organizations should be prohibited from expanding their powers in order to adapt to the changes in technology and competition in

competition in financial markets. The Board has repeatedly called for a comprehensive Congressional review and reform of the laws regulating the activities of banking organizations in the United States in order to establish a structure that would allow for the exercise of broader powers consistent with basic principles of safety and soundness and avoidance of conflicts of interest, undue concentration of resources, and unfair competition. For example, the Board has consistently supported insurance agency authority for banking organizations.[11]

The Board has, however, expressed concern with state initiatives that are designed to attract jobs and revenues to the state by allowing out-of-state banking organizations the ability to avoid federal banking policies by acquiring banks in the state that have the authority to export nonbanking activities not available to the organizations under federal law to the rest of the nation, but not to engage in these activities in the authorizing state itself. The Board has noted that this type of initiative could promote potentially destructive competition among the states with adverse consequences for the national interest in safeguarding the safety and soundness of the nation's financial system and the federal deposit insurance funds.[12]

The Board believes that this case provides further demonstration of the urgent need for Congress to take up the important questions of banking reform and structure. In the Board's view, Congress is clearly the appropriate forum in which to resolve major issues of national banking policy, including the resolution of the is-

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[11] *E.g.*, Statement by Governor H. Robert Heller before a Subcommittee of the Committee on Energy and Commerce, U.S. House of Representatives, Sept. 9, 1988. 74 Federal Reserve Bulletin 743 (1988).

[12] *See, e.g.*, Statement by Chairman Paul A. Volcker before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Jan. 21, 1987. 73 Federal Reserve Bulletin 199, 202 (1987).

sues of safety and soundness and competitive equity associated with state initiatives in the area of bank powers expansion. Initiatives such as that in Delaware, however, necessitate a decision by the Board on aspects of these questions that are within the area of the Board's responsibilities under the BHC Act.

DISCUSSION

As noted, the issue raised by the petition for enforcement is whether Citicorp is authorized under the BHC Act to retain the shares and control of Family Guardian after it begins conducting the broad insurance agency and underwriting business authorized by the Delaware statute. Under the terms of the BHC Act, a bank holding company may not acquire or retain, directly or indirectly, the shares or control of any company (other than a bank) unless the acquisition is authorized by one of the exceptions to this general prohibition specified in the Act.[13]

Citicorp here relies on the state bank operating subsidiary rule in Regulation Y (section 225.22(d)(ii)), which, as noted, provides a regulatory exception to the

[13] Section 4 of the BHC Act provides that, except as set forth in the Act, bank holding companies may not (1) acquire or retain direct or indirect control of voting shares of "any company which is not a bank," or (2) engage directly in activities other than banking or managing or controlling banks and other subsidiaries authorized under the Act and those activities permitted under the closely related to banking standards of section 4(c)(8) of the Act. 12 U.S.C. § 1843(a). Indirect control for purposes of this prohibition is defined to include shares held by any subsidiary. *Id.*, § 1841(g)(1). By their terms, the nonbanking prohibitions in section 4 do not limit activities conducted directly within holding company subsidiaries that are banks. *Merchants National Corp.*, 75 Federal Reserve Bulletin 388 (1989), *aff'd*, 890 F.2d 1275 (2d Cir. 1989), *petition for cert. filed*, U.S. Supreme Court (April 18, 1990) (No. 89-1620). *See* 53 Federal Register 43915, 48921-24 (Dec. 5, 1988) for a more detailed legal analysis of the nonbanking provisions of the Act, which is incorporated herein by reference.

general nonbanking prohibitions of the BHC Act to allow state banks that are owned by bank holding companies to establish, without prior Board approval under the Act, wholly owned subsidiaries that engage only in activities that the bank could conduct directly. The Board adopted this rule in 1971 to allow holding company banks to establish operating subsidiaries to engage in activities the bank could conduct directly. At the time that it adopted this provision, the Board recognized that the exemption could become the focus for evasion of the Act. The Board noted, however, "the absence of evidence that acquisitions by holding company banks are resulting in evasions of the Act," but stated that it would review the merits of the decision to adopt this regulatory exemption in light of its experience in administering the Act.[14]

Noting several recent developments, including the enactment of the insurance prohibitions in section 4(c)(8) of the BHC Act and enactment of a number of state statutes that broadly authorize state banks and their subsidiaries to engage in various nontraditional activities, the Board has requested comment on rescinding the operating subsidiary rule as inconsistent with the nonbanking provisions of the Act.[15] The Board held a public hearing on this proposal in 1989, and currently has this rulemaking proceeding under review. The Board believes that it is neither necessary nor appropriate to decide that rulemaking in the context of this petition for enforcement, because the Board finds that the current operating subsidiary rule does not provide Citicorp with authority to retain Family Guardian after it commences insurance activities beyond those permissible under section 4(c)(8)(A) of the Act.

The Board's operating subsidiary rule permits activities for a subsidiary of a state bank "subject to the same

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[14] 36 *Federal Register* 9292 (May 22, 1971).

[15] 53 *Federal Register* 48915 (Dec. 5, 1988).

limitations as if the parent bank were engaging in the activity *directly*." Although one provision of the Delaware statute does state that a bank chartered by Delaware shall have the power to transact the business of insurance in accordance with the state Insurance Code,[16] the statute further mandates that any activity so authorized must be conducted through a separate department or division.[17] In addition, the statute also establishes a comprehensive set of financial, operational, and regulatory limitations that separate virtually every aspect of the insurance division's business from the bank. While no one of these restrictions in itself is necessarily determinative, the cumulative effect of all of these restrictions in the Delaware statute is, in the Board's judgment, to compel the insurance division to function in practice and for all intents and purposes as a distinct corporate entity separate from the bank. In light of this pervasive corporate-like separation, the Delaware statute cannot reasonably be viewed as authorizing a state-chartered bank itself to conduct insurance activities directly, as required by the terms of the operating subsidiary rule in Regulation Y. Thus, because Family Guardian's parent bank, Citibank Delaware, may not engage in the general insurance business directly within the meaning of the operating subsidiary rule, Citicorp may not rely on that rule as authority for Family Guardian to conduct such activities under the BHC Act.

With regard to structural restrictions, the Delaware statute requires that the insurance division must maintain financial records separate and distinct from other records of the bank.[18] In addition, the bank is prevented from allocating more than 25 percent of its current total capital to the insurance division.[19] Such limits on capital

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[16] House Bill No. 193, Section 2.

[17] *Id.*, Section 4.

[18] *Id.*

[19] *Id.*, Section 10.

attributed to specific functions typically do not apply to activities conducted within a single entity, but rather to investments in a subsidiary by a parent company.[20] Indeed, this limit on allocation of capital to the insurance business is contained in the provision limiting investments by Delaware banks in securities of other companies.[21]

The Delaware statute also mandates pervasive financial and operational firewalls that insulate the insurance division from the bank. First, the minimum capital that the bank is required to maintain "in its banking or trust company business" under the banking laws may not be used by the insurance division to meet its separate capital requirements under the Insurance Code.[22] Second, under the state statute, the bank is not financially responsible for the insurance division. The statute expressly provides that the assets of the bank are applicable to the payment of the liabilities, obligations, and expenses of the bank only, and not to the liabilities, obligations, and expenses of the insurance department. The liabilities and expenses of the bank may be paid only out of the assets of the bank and not out of the assets of the insurance division.[23] The statute also makes explicit the converse of this requirement: the assets of the insurance division may only be used to pay the liabilities and expenses of that division,

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[20] *See, e.g.*, 12 C.F.R. § 211.5(b), (c) (limitations on investments abroad by banking organizations).

[21] Del. Code Ann. tit. 5, § 910.

[22] House Bill No. 193, Section 3. The Insurance Code is contained in Title 18 of the Delaware Code Annotated.

[23] *Id.*, Section 8. The fact that any insurance policies issued are not direct liabilities of the bank and that only the assets of the insurance division are applicable to the payment of such policies or claims under the policies must be disclosed to all insurance customers. *Id.*, Section 13.

which must be paid solely out of the assets of the division.[24]

Third, under the Delaware statute, the bank may transact business with the insurance division only on an arm's length basis—on the same terms and under circumstances substantially the same as for a comparable transaction with a third party.[25] Ordinarily, there is no need for such a requirement for activities that are being conducted within the same entity. Instead, as in section 23B of the Federal Reserve Act,[26] the arm's length requirement has been imposed to regulate transactions between a bank and separate affiliates.

Fourth, the Delaware statute makes clear that the insurance division is to be treated as a "separate corporation"—thus an entity distinct from the bank itself—for regulatory purposes, specifically, for purposes of bank lending limits.[27] Fifth, the statute imposes the same kind of limits on the distribution of earnings from the insurance activities it authorizes as are applicable to dividends paid to stockholders by a separate insurance company.[28] Thus, for this purpose, the bank is treated as a shareholder of the insurance division rather than part of the same entity. Finally, the Delaware statute restricts the use of certain customer information obtained by the bank in connection with a request for an extension of credit.[29]

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[24] *Id.*, Section 22. Although the Delaware statute has no explicit requirement that the insurance division have separate employees from the bank, the fact that the expenses associated with the division's employees may be paid only out of the assets of the division would appear to segregate these employees from those of the bank.

[25] *Id.*, Section 4.

[26] 12 U.S.C. § 371c-1.

[27] House Bill No. 193, Section 9; Synopsis of House Bill No. 193, Section 8.

[28] *Id.*, Section 33; Insurance Code, Section 4922(a).

[29] House Bill No. 193, Section 4.

With respect to regulation of the insurance business, under the Delaware statute, the insurance division is treated almost exclusively as a company that is not a bank. Not only must the insurance division conduct the insurance business in accordance with the state Insurance Code,[30] but the statute expressly states that, for purposes of the Insurance Code, the insurance division (but not the bank) is deemed to be "a separately incorporated subsidiary" of the bank "with separate capital accounts, assets and liabilities."[31] Thus, the bank itself is not made subject to the state regulation applicable to insurance companies, but the insurance division is so regulated. Because of this treatment, the insurance division is generally subject to the substantive regulatory provisions of the Insurance Code and to the supervision of the state Insurance Commissioner, including that commissioner's power to examine the operations of the insurance business.[32] More importantly, however, the Delaware statute severely limits the routine supervisory and examination authority of the Bank Commissioner over the insurance division. Specifically, the Bank Commissioner has jurisdiction over the division only when he determines that the insurance activity "is likely to have a materially adverse effect on the safety and soundness of the bank."[33]

Because it is treated as a separately incorporated subsidiary of the bank for purposes of the Insurance Code, the insurance division is subject to the minimum capital requirements of that Code.[34] As pointed out above, the capital of the bank may not be used to satisfy these requirements. In addition, the Delaware statute expressly

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[30] *Id.*

[31] *Id.*, Section 17.

[32] Insurance Code, Sections 301-34.

[33] House Bill No. 193, Section 5.

[34] *Id.*, Sections 17, 19; *see* Insurance Code, Section 511(a).

provides that the assets and liabilities of the bank are not considered in determining the financial condition of the insurance division;[35] and the statute provides that the Insurance Commissioner, not the Bank Commissioner, has the authority to take possession of the business of the insurance division in order to conserve or to liquidate its business.[36] This action can apparently be taken by the insurance supervisor without causing the closing of the bank. Finally, the insurance division is taxed as if it were an independent insurance company; the earnings from the insurance business are expressly exempted from the franchise tax the state imposes on the net income of banks.[37]

The Board recognizes, as Citicorp points out, that under the Delaware statute the insurance division operates under the charter of the bank and is not technically a separate corporation with its own shareholders and board of directors. However, the Board does not believe that formal characteristics alone should be determinative in assessing the scope of the operating subsidiary exception in section 225.22(d)(ii). Indeed, the terms of the regulation itself require that the scope of the activities it permits for subsidiaries of holding company state banks must be determined in light of the practical restrictions on the powers of the parent bank, since the rule prescribes that in conducting a specific function the subsidiary must follow the same limitations as if the bank were engaged in the activity directly. Here, as is evident from the face of the Delaware statute, the limitations imposed on the conduct

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[35] House Bill No. 193, Sections 21, 24.

[36] *Id.*, Section 38.

[37] *Id.*, Sections 14, 16; Del. Code Ann. tit. 5, § 1101(a). The Delaware statute does contain a handful of exceptions for the insurance division from the substantive provisions of the Insurance Code. *E.g.*, House Bill No. 193, Sections 25, 30, 32, 35. However, none of the regulatory provisions relates to an essential element of the structure, operations, or regulation of the division.

of the general insurance business so comprehensively and pervasively insulate the insurance division from the bank that it would be unreasonable, in the Board's judgment, to view the bank as directly authorized to offer the expanded services, as is required by the terms of the rule.

Moreover, this conclusion is also consistent with the basic objective that motivated the Board's original adoption of the operating subsidiary rule. As the terms of the rule demonstrate, the rule was meant to allow state banks in holding company systems the operational flexibility of establishing operating subsidiaries to conduct activities the bank performed directly. Historically, the activities of banks have been circumscribed by the chartering authorities in order to protect the safety and soundness of the institutions and to guard against harmful conflicts of interest and unfair competition. The permission granted by the operating subsidiary rule was premised on the Board's belief that this traditional concern for safeguarding the deposit-receiving function would constrain the expansion of bank activities (and thus of the activities of subsidiaries of holding company state banks), so that the activities permitted by the rule would not result in evasions of the purposes of the BHC Act. 36 *Federal Register* 9292 (May 21, 1971).

Here, it is evident from the terms and structure of the Delaware statute that the state, in apparent recognition of the enhanced potential for risks associated with certain aspects of the insurance underwriting business, has not authorized that business for its depository institutions directly, but through a structure that seeks the risk minimization advantages available through the corporate separation of the banking and insurance businesses. The entire practical effect of the Delaware statute is to sanction expanded insurance activities only for an entity that in substance is a separate corporation and that is not a bank. The only apparent reason the statute nominally authorizes the bank itself, through a separate division, to

conduct the insurance business, rather than authorizing the activity through a separate corporate subsidiary of the bank, is to attempt to bring the state law within the scope of the Board's operating subsidiary rule for the benefit of insurance subsidiaries of state banks that are owned by holding companies. If the statute had required the activity to be conducted only through a separate subsidiary corporation of the bank in order to minimize the risk to the bank and its depositors and the potential for conflicts of interest, unfair competition, and other adverse effects, bank holding companies could not have availed themselves of the statute because of the operating subsidiary rule. Under that rule, a holding company bank may control a nonbank subsidiary only if it engages in activities the parent bank could conduct directly. Accordingly, viewing the state bank operating subsidiary rule as applicable in circumstances such as presented under the Delaware statute frustrates the purposes of the rule and allows a serious evasion of the provisions of the BHC Act.

Given the extraordinary extent to which the Delaware statute isolates the insurance business from the traditional, deposit-receiving operations of state-chartered banks, the Board believes that its treatment of that statute for purposes of the operating subsidiary rule is consistent with its past practice. Although the Board, as Citicorp notes, has in the past not objected to insurance activities conducted in a subsidiary of a holding company bank under state law where the parent bank has engaged in the same activities through a separate department,[38] the relevant state law in those cases did not require that the insurance functions be carried out in a separate department or mandate the insulation of insurance activities from the rest of the bank to the substantial extent directed by the Delaware statute.[39]

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[38] *E.g., Merchants National Corp., supra.*

[39] *See, e.g.*, Ind. Code Ann. § 28-1-11-2 (Burns 1986).

Nor is the Board's decision here inconsistent with its prior treatment of statutes in three states that allow savings banks to engage in life insurance activities, since these statutes have only some, but not all, of the operational, structural, and regulatory firewalls embedded in the Delaware statute. Indeed, the Board never decided that subsidiaries of saving banks engaged in the life insurance business under these statutes were permitted to engage in the same activities under section 225.22(d)(ii), but instead elected to defer such a determination.[40] Before the Board resolved the issue, however, Congress, in an amendment to the BHC Act in 1987, expressly authorized savings bank life insurance activities if, among other things, the activities are conducted directly in the bank.[41] Accordingly, the Board has never considered whether an operations subsidiary of such a bank could engage in the activities under the operating subsidiary rule. In any event, although these state laws do require that insurance functions be separated to some degree from the operations of the bank, the insulation prescribed is not as comprehensive and complete as that directed by the Delaware statute.[42]

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[40] *First Essex Bancorp, Inc.*, 73 *Federal Reserve Bulletin* 354, 355 (1987), *Newworld Bancorp, Inc.*, 73 Federal Reserve Bulletin 357, 358-59 (1987).

[41] 12 U.S.C. § 1842(f)(3).

[42] For example, under the Massachusetts statute authorizing savings bank life insurance (Mass. Gen. L. Ann. ch. 178), the insurance department must be managed under the general laws relating to savings banks and is subject to the supervision of both the insurance and bank commissioners (*id.*, §§ 6, 26-28), while under the Delaware statute, in contrast, the insurance division operates principally under the Insurance Code and the power of the Bank Commissioner over the division is restricted. In addition, the Massachusetts law lacks many of the key firewall provisions prescribed by the Delaware statute, such as the limitations on the use of the bank's capital for insurance purposes and the requirement of arm's length transactions between the bank and the insurance division.

Banks also conduct a number of traditional functions in separate departments, like dealing in municipal securities and offering trust services. But in each case, the separation of these operations from the rest of the bank required by the applicable regulatory framework does not even approximate the thorough insulation mandated by the Delaware statute.[43]

In sum, the Board finds that Citicorp may not avail itself of the provisions of section 225.22(d)(ii) to retain control of Family Guardian for purposes of the BHC Act to the extent Family Guardian engages in insurance activities not permitted to bank holding companies and their nonbank subsidiaries under section 4(c)(8) of the BHC Act. Accordingly, Family Guardian may not engage in insurance activities authorized under the Delaware statute other than those that are permissible under section 4(c)(8) of the BHC Act and for which it has secured the necessary approval under that section.[44]

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[43] For example, like the insurance division required by the Delaware statute, the municipal securities department of a bank under the securities laws must keep separate records, is regulated separately from the bank, and is subject to limits on transfer of information from the bank. *See* 15 U.S.C. §§ 78c(a)(30), 78o-4; 12 C.F.R. § 208.8(j). However, the municipal securities department is not subject to the remaining host of restrictions that the Delaware statute imposes on the insurance division, like the bank's lack of liability for the obligations of the division, the restrictions on the use of the bank's capital for the insurance business, and the restriction of the bank regulator's routine supervisory authority over the insurance division.

[44] In any event, even if Citibank Delaware, Family Guardian's parent bank, is viewed as being authorized by the Delaware statute to engage in the general insurance business within the scope of the exemption in section 225.22(d)(ii), the bank cannot be viewed as authorized to engage in such a business in those states (approximately 22) where banks are effectively under state law, by licensing requirements or other similar restrictions, from providing insurance activities. Specifically, in a number of these states, banks are precluded from obtaining the license necessary to provide insurance services in that state. Thus it is clear that in those states Family

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Therefore, pursuant to the provisions of sections 4(a) and 5(b) of the BHC Act (12 U.S.C. §§ 1843(a), 1844(b)), Citicorp should immediately cause Family Guardian to cease providing any further insurance as principal, agent, or broker, except as authorized and approved by the Board under section 4(c)(8)(A) of the Act.

By order of the Board of Governors, September 5, 1990.

/s/ William W. Wiles
WILLIAM W. WILES
Secretary of the Board

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[44] [Continued]
Guardian, under the terms of the regulation, may not provide general insurance services.

Concurring Statement of Governor Seger

I concur with the result reached by the majority that the proposal by Citibank Delaware to conduct broad insurance activities through Family Guardian Life Insurance Company does not meet the requirements of the Board's Regulation Y dealing with operating subsidiaries of holding company banks. I reach this conclusion for reasons different from those stated by the majority, however.

As a general matter, I do not object to proposals by the states to authorize their state banks to engage directly or through subsidiaries in activities at any location provided that the activities may be conducted within the bank's home state without restriction as well. I believe that states should be permitted to delineate the types of activities that banks may conduct within their borders. One of the virtues of the dual banking system, in my judgment, is that it allows the states to serve as laboratories for the development and expansion of banking services and activities within their boundaries.

My disagreement with the Citicorp arrangement stems from the fact that the state here has severely limited banks owned by out-of-state holding companies from conducting the insurance business within the state. This means that out-of-state banking organizations can use the state bank franchise to operate an insurance business throughout the rest of the country, but may not effectively offer those services within Delaware.

Not only is this kind of state authorization inconsistent with the principles underlying the dual banking system, as I have previously stated in connection with a somewhat similar statute in South Dakota, this kind of expansion of state powers, shows, in my judgment, that the state does not treat the expanded powers as true banking activities for Delaware banks owned by out-of-state banking organizations. In these circumstances, the Board's

operating subsidiary rule should not be interpreted to permit such activities.

I note that the majority has not reached the question of the validity of the Board's operating subsidiary rule in deciding this case. I continue to believe that the Board's regulation is appropriate and valid, and believe that this opinion is consistent with my view of the Delaware statute here.

September 5, 1990

Concurring Statement of Governor Angell

I concur with the Board's conclusion in this matter that the Bank Holding Company Act does not permit Citicorp to retain the shares of Family Guardian Life Insurance Company to the extent Family Guardian takes advantage of the recently-enacted Delaware statute to engage in insurance underwriting or agency activities that are not permissible for bank holding companies under section 4(c)(8) of the Act. However, I reach this conclusion on different grounds than the Board. In my view, the expanded insurance activities of Family Guardian are inconsistent with the nonbanking prohibitions in the Act regardless of whether the exception contained in the operating subsidiary rule in Regulation Y applies in this case.

My view is based on the plain and unambiguous language of section 4 of the Act. This section by its terms prohibits a bank holding company from acquiring or retaining control, directly or indirectly, of any company other than a bank unless that company's activities are authorized under one of the nonbanking exceptions in the Act. Family Guardian, a multimillion dollar insurance underwriting company, is clearly not a bank as defined in the Act, and, under the Act, there is simply no question that Family Guardian is controlled by Citicorp. As the terms of the Act make clear, a company controlled by a bank that is in turn a subsidiary of a bank holding company is indirectly controlled by, and treated as an indirect subsidiary of, the parent holding company. As a nonbank subsidiary of a bank holding company, Family Guardian is required to limit its activities to those permitted for bank holding companies and their nonbank subsidiaries under the Act. Under the 1982 amendment to section 4(c)(8) of the Act, the Board no longer has the discretion to permit a bank holding company or any of its nonbank subsidiaries to underwrite or sell insurance beyond the seven situations set forth in the statute.

For these reasons, I agree with the Board's decision that Family Guardian must cease any insurance activity other than those previously approved for Family Guardian by the Board under section 4(c)(8) of the Act.

September 5, 1990